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TAGS: [EFIN](#) [ETRD](#) [ECON](#) [PREL](#) [XH](#) [UP](#)  
SUBJECT: UKRAINE: IMF APPEALS TO G7, EU TO FINANCE BILLION  
DOLLAR BUDGET SHORTFALL

Classified By: AMBASSADOR, REASONS 1.4(B) AND (D)

Summary

1. (C) On February 5 IMF Mission Director Ceyla Pazarbasioglu told the G7 and EU ambassadors that Ukraine faces a \$3.75 to \$6.25 billion budget shortfall this year. She appealed to the ambassadors for direct financial support for Ukraine's budget, arguing that Ukraine had no other options to finance the deficit without borrowing directly from the central bank. If the GOU cuts spending substantially and Ukraine's political leadership publicly joins forces to sell the cuts to the population, then Ukraine is deserving of international support, because the alternative - a severe destabilization of the economy - would be in nobody's interest, she argued. Pazarbasioglu said she cannot yet recommend that the IMF Board disburse the next \$1.87 billion tranche of the \$16.4 billion Stand By Arrangement (SBA). Before doing so, the IMF will require a revised budget that cuts expenditures and is more fiscally sustainable, and a clear and open commitment by President Yushchenko, PM Tymoshenko and Rada speaker Lytvyn to back the measures. Pazarbasioglu was confident that Ukraine would fulfill these conditionalities, because the leadership "now understands what it means if we pack up and leave." The World Bank supported the IMF appeal and offered to use one of its loan facilities as a conduit to channel additional assistance. None of the ambassadors present indicated whether their countries might support the appeal, but the Japanese ambassador said his country had been approached by the GOU and had already declined. End summary.

IMF Makes Appeal to G7, EU

2. (C) IMF Mission director Ceyla Pazarbasioglu told the G7 and EU Ambassadors on February 5 that Ukraine's budget will face a budget shortfall of up to UAH 50 billion (\$6.25 billion) this year. Acknowledging that the balanced budget foreseen in the \$16.4 billion Stand By Arrangement (SBA) was no longer realistic, she said the IMF and World Bank had revised downward their forecast for this year, and are now expecting Ukraine's economy to contract by five percent. The expected funding shortfall will be roughly four percent of GDP, Pazarbasioglu said, and cannot be covered by conventional sources of borrowing. It was unlikely that the international markets would recover sufficiently to serve as a source of borrowing, there was no domestic government debt market, and the struggling banking system could not lend to the GOU as well, "unless it somehow convinces the population to put the billions of dollars now under the mattresses back into the banks," she said. The last remaining domestic option was direct borrowing from the National Bank of Ukraine

(NBU), which would monetize the budget shortfall and further destabilize the financial sector and economy as a whole.

13. (C) Pazarbasioglu appealed to the ambassadors for direct financial support to help Ukraine meet the expected budget gap, arguing that the situation had deteriorated faster and further than the IMF or anyone had expected when the \$16.4 billion Stand By Arrangement (SBA) was approved in October. Direct budgetary support would help stabilize Ukraine's fiscal situation and give it and the IMF "breathing space" to move forward implementing the SBA more broadly. The country deserved international support, if the political leadership and parliament did everything in their power to improve the budget and displayed political unity, she argued. The alternative -- a severe destabilization of the economy -- was in nobody's interest, she said.

#### Current Budget Has \$6.25 Billion Gap With Realistic Assumptions

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14. (C) The current budget, which forecasts a deficit equal to 3 percent of GDP, was based on unrealistic assumptions, including a 0.4 percent growth rate, she said. A revised budget forecast, using more realistic assumptions, leads to the expected UAH 50 billion budget gap. The GOU has said it can reduce spending by about UAH 10 billion (\$1.25 billion), but that further cuts were not possible both for structural and political reasons. Separately, World Bank economist Pablo Saavedra said the GOU was saying it could cut a further UAH 5 billion (\$625 million) at most. Allowing for a margin of error, the remaining budget gap would be anywhere between UAH 30 and UAH 40 billion (\$3.75 - \$5 billion), Pazarbasioglu

and Saavedra said. Pazarbasioglu said this year's budget, as passed, does little except "pays wages and pensions and fills holes at the pension fund and Naftohaz," and foresees virtually no capital expenditure. IMF and World Bank experts were now working with the GOU on budget cuts and restructuring, a process that would take about two weeks. Measures would focus on reducing subsidies for the pension fund and Naftohaz and on restructuring the budget to make it more sustainable over a longer period, she said.

#### New Budget, Political Unity Necessary for Next Tranche

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15. (C) Pazarbasioglu planned to return to Washington on February 6. She said the Mission was not yet ready to recommend that the IMF Board approve disbursement of the next \$1.87 billion tranche in the SBA later month. Before making a recommendation, the IMF would require a revised budget, approved by the Rada (parliament), that substantially reduces the expected funding gap in the budget. The budget would also need to show more fiscal sustainability, as the IMF now expects the world economic crisis to continue into 2010. Finally, and most importantly, the IMF will require clear public commitments by President Yushchenko, PM Tymoshenko and Rada Speaker Lytvyn that they will jointly support the needed budget cuts, and jointly sell them to the Ukrainian public. She said that the IMF also hoped to have assurances of additional international support when it went into the Board meeting to approve the disbursement. As things now stand, that meeting would take place in late February at the earliest.

16. (C) Pazarbasioglu said the never-ending political infighting between Yushchenko and Tymoshenko was a major obstacle to a more realistic budget. Conceptually, Tymoshenko now understood the fiscal restrictions facing Ukraine, and showed detailed knowledge of the budget during a four hour planning session with the IMF Mission. However, she told Pazarbasioglu that she could not support further budget cuts because she knew that she could not sell them politically, as Yushchenko would attack her for whatever steps she took.

17. (C) Political unity will therefore be a key conditionality

for disbursement of the next tranche, Pazarbasioglu said. She pointed out that Marek Belka, director of the IMF's Europe Department, came to Kyiv at short notice this week to deliver a stern message to Ukraine's political leadership on the need for decisive action, political unity, and "political truth" directed towards the Ukrainian public. Pazarbasioglu said Belka received political commitments from Yushchenko, Tymoshenko, Lytvyn, and even Party of Regions MP Azarov, who surprisingly joined the IMF's meeting with Lytvyn. Responding to a question from a skeptical German ambassador, Pazarbasioglu confirmed that they received these commitments individually, in separate meetings, but never met with the political leadership in a joint environment. Nonetheless, Pazarbasioglu was confident that Ukraine would fulfill the IMF's conditions, and that the IMF Board would approve the disbursement of the next tranche as foreseen in the SBA, because Ukraine "now understands what it means if we pack up and leave." Their expressed willingness to demonstrate unity was convincing, although she conceded that many might think her to be "romantic and naive" to expect Yushchenko and Tymoshenko to put their bitter political rivalry aside for the good of the country.

#### IMF Asks For Joint G7, EU Message

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¶8. (C) Pazarbasioglu and World Bank Country Director Martin Raiser also appealed to the assembled ambassadors to deliver a joint message to Ukraine's political leadership on the need to act together and decisively. It would be ideal if the countries could offer a prospect of financial support in return for Ukraine's compliance, but in any case delivering the message would help the IMF at the present juncture, Pazarbasioglu said. Both IMF and World Bank agreed to participate in such a meeting.

¶9. (C) Earlier in the week, PM Tymoshenko said publicly that the GOU had approached six countries for financial support, and that two had already committed. None of the assembled ambassadors said that their governments had pledged support. In addition to the U.S., only Japan had been approached, and its Ambassador said that his government had declined the request.

#### World Bank Offers Conduit for Multilateral Support

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¶10. (C) The World Bank's Raiser offered the World Bank's Development Policy Loan (DPL) program as a conduit to deliver multinational budget support, citing examples in other countries where the World Bank and individual government donors had teamed together to deliver support within the framework of the DPL. The World Bank had budgeted a further \$1 billion DPL loan to Ukraine later this year. All DPL loans are disbursed only after a recipient country meets clearly specified benchmarks, and Raiser offered to integrate the newest IMF conditionalities into the catalog of benchmarks already foreseen for Ukraine, which will include pension reform, improved targeting of social spending, safeguarding of capital expenditures, and selected structural economic reforms. None of the ambassadors present commented on Raiser's proposal.

#### Other Topics

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¶11. (C) Pazarbasioglu briefed the ambassadors on the state of other components in the SBA:

#### External Financing Gap

-- The IMF is confident that parent banks will roll over the debt of their Ukrainian subsidiaries this year, but is far less confident that debt due by banks to non-parent lenders abroad will be rolled over.

-- Other factors might help reduce the expected external

financing gap: the Hryvnia devaluation, swifter and deeper than the IMF had expected, would help the current account balance, and Ukraine's metal exporters were reporting a certain stabilization in their exports, partly because of the weaker Hryvnia.

#### Banking Sector

-- The banking system was still nowhere close to stability, and pressure on deposits remained high. Much of the nervousness leading to withdrawals was being caused by the conflicting statements and mutual accusations of the political leadership.

-- Although the NBU's bank diagnostics were of high quality, still no substantial progress had been made to establish the needed recapitalization and resolution mechanism.

#### NBU, MOF

-- Cooperation between the NBU and Ministry of Finance was improving. However, both remained leaderless, and the GOU and President needed to act quickly to create a strong and decisive leadership in both institutions.

-- A strong coordinator was needed to manage affairs between the NBU and MOF on bank recapitalization and resolution, and the IMF was optimistic that a person would be named shortly.

-- The NBU had lost credibility as an institution, not only because of its own visible failings, but because the Tymoshenko government had regularly attacked it and so diminished its standing in the eyes of the Ukrainian public. The attacks also forced the NBU leadership to become far too cautious in many of its actions out of fear of political reprisal.

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